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# History of the international monetary system and its potential reformulation

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History of the International Monetary System  
and its Potential Reformulation

Catherine A. Karczmarczyk

Honors Thesis Project

Dr. Anthony Nownes and Dr. Anne Mayhew

02 May 2010

# **HISTORY OF THE INTERNATIONAL MONETARY SYSTEM AND ITS POTENTIAL REFORMATION**

## **Introduction**

The year 1252 marked the minting of the very first gold coin in Western Europe since Roman times. Since this landmark, the international monetary system has evolved and transformed itself into the modern system that we use today. The modern system has its roots beginning in the 19<sup>th</sup> century. In this thesis I explore four main ideas related to this history.

First is the evolution of the international monetary system. Within this I will explore the different eras that make up this time. First is the classic gold standard, then the interwar period, and followed by Bretton Woods. This section concludes with a discussion on the current era, also known as the dirty float.

The second section will explore the transition period of the 1990s. This section explores the Asian Financial Crisis in detail and also discusses the origins of the euro zone. These sections begin the analysis portion of the thesis, and while they do give a certain degree of background, the section largely serves as a transitional section.

The third section is an analysis of the current monetary system. The world is facing two major issues right now, the potential collapse of the euro zone and the Chinese holding of US Treasury debt. In this section, I will explore these issues in

depth and highlight how the history of the international monetary system has led us to this point.

In the fourth and final section, I highlight several possibilities for reform. This is not a comprehensive plan of action, but rather ideas of where I see reform is needed. Actual reform possibilities have been circulating for years, and these ideas represent a combination of these.

## **Evolution of the International Monetary System**

### **The Classic Gold Standard (1870-1914)**

In this section, I will discuss the rise and importance of the gold standard in Great Britain, the Bank of England as a lender of last resort, and the results of the continent joining the gold standard. I will conclude with a brief discussion of the end of the prewar gold standard and the overall importance of its evolution to both the interwar and post war periods but also to the modern monetary system today.

#### *The Rise of the Gold Standard in Great Britain*

The classic gold standard started for most countries in and around the 1870s, but for Great Britain, it was far earlier. Many date the advent of the gold standard in Britain to 1717, when Sir Isaac Newton set the price of gold at too low a rate, causing silver to disappear from the country entirely. The actual date of demonetization didn't occur until 1774, the year when gold was recoinced, silver was recognized as subsidiary, and limits were set on the use of silver coins in excess of 25 pounds.

In the years leading up to the adoption of the gold standard by continental Europe, Britain faced several instances of convertibility issues. When the Reign of Terror took place in early 1793, there was a sharp outflow of capital in the form of both gold and silver from France. This produced large amounts of liquidity in Britain, fueling an ongoing mania to its peak. Eventually the assignat, the French paper currency of the time, collapsed, forcing a reflow of money. The British people panicked, and a bank run ensued. In response, the British government ordered the Bank of England to suspend convertibility, well before reserves ran out in an effort to keep gold reserves from becoming exhausted if all the increased notes to finance the war were cashed in. In 1825, not long after convertibility resumption, Britain once again faced the threat of a bank run. The Bank of France stepped in to aid them at this time, easing the fear of suspension.

Britain recognized the need to act. Suspension of the currency led to an inconsistent system always facing bank runs. At this time, however, there were two schools of thought, the Currency School and the Banking School, each with differing ideas on how the money supply should be handled. The intricacies of these two schools are beyond the scope of this paper, but let it suffice to say that the Banking Act of 1844 was a compromise between the two. For the Bank of England, it created an Issue Department, which was responsible for the issue of paper currency, and it would also create a Banking Department, responsible for making loans and discounts up to a multiple of its reserves of bank notes that had been produced by the Issue Department (Kindleberger 59).

Apart from a fixed initial quantity of Bank notes backed by government securities, “every note issued had to be backed by bullion in the vault of the Issue Department. This limited the quantity of Bank notes in an effort to adhere to the principle that “the way to assure a sound paper currency is to require any increase in its quantity to be backed pound for pound by increases in bullion reserves held by the central bank” (Dillard 378). Basically, at this point in the history of banking in England, security was more sacred than flexibility. Choosing this path, however, made it difficult for the Bank of England to supply credit in times of emergency. When the Crises of 1847, 1857, and 1866 erupted, the Bank of England was given permission by government to break the law by issuing notes not backed by bullion.

The Bank Act of 1844 had an even more fundamental issue however. It presumed that “control of the quantity of bank notes, and the reserves behind them, was the chief function of central banking” (Dillard 378). British banking, however, was entering a new phase, the checking system.

#### *The Bank of England as a Lender of Last Resort*

In the new checking phase of banking, “the most important function of the Bank of England was as the holder of the central reserves supporting the checking system and as a lender of last resort in emergencies” (Dillard 379). There had long been debate in England over whether the lender of last resort should be the Exchequer or the Bank of England, but the actions of the Bank Act of 1844, left little doubt as to whom the job would fall. It was around this time of this new phase that it became startlingly clear that the Bank of England was no longer “just any other bank.” Its

reserves were too large and its role as a credit custodian too widely accepted. It had to “stand ready to lend its reserves freely in critical credit situations; for mere reluctance on its part would make credit even tighter and precipitate a crisis or make an existing crisis worse” (Dillard 379).

Private banks and other such institutions needed bank notes (the legal tender) to provide for their customers. In order to do this, however, they had to have access to the central bank. Such a necessity gave the Bank of England a certain degree of power. The Bank of England “could make the bankers and bill brokers pay for new money by raising the rate of interest, but [at the same time] it could hardly refuse to lend, provided the borrowers had good securities to sell or pledge against their loans” (Dillard 379). The power, and responsibility, comes in because now because the Banking Department (now the powerful department due to the rise of checking) was held responsible for the credit of all banks, as their abilities depended on the liquidity of the central bank.

#### *Continental Europe Joins the Gold Standard*

The gold standard in England had been around for several years before continental Europe decided to also join in. During the time that Britain had been building and redefining it's (and eventually the world's) banking system, they had also been experiencing the Industrial Revolution. This industrialization left them as the “world's leading economic power and the main source of foreign finance” (Eichengreen 17). Countries desperately wanted to trade with such an economic resource, and the bimetallic standards of many of these countries didn't facilitate

easy trade. Portugal had decided early on in 1854 that its trade with Britain was crucial, and they in response adopted the gold standard in 1854. Other countries, however, had yet to come to that conclusion.

When a series of events, including a brief bout of inconvertibility (associated with the Franco-Prussian War), declining transportation costs, and large silver discoveries in the 1850s (in places such as Nevada), considerations of joining the gold standard were pushed even further. Ultimately, the final incentive came in 1871, when Germany, the leading industrial power of continental Europe, chose to liquidate its silver holdings in an effort to open up more trade with Great Britain. The result was a chain reaction caused by “the incentive for each country to adopt the monetary standard shared by its commercial and financial neighbors (Eichengreen 17). By the end of the nineteenth century, Spain was the only European country still on inconvertible paper. In the rest of the world, the United States, Japan, Russia, India, and Latin America all also instituted gold convertibility. Silver remained the monetary system only in China and a few other small countries.

Under the gold standard, “the exchange rates of these major industrial countries were firmly pegged within narrow bands (the gold points) in an environment free of significant restrictions on international flows of financial capital” (Bayoumi 165). The rate of convertibility and price of gold was fixed, and under this fixed system, the world entered a period of trade and globalization previously unmatched in history. The stability of exchange rates under this system led to the openness of the markets and buoyancy of trade, which in turn offered



support within themselves of the gold standard. There were, however, pressures on the Bank of England with this increased use of their reserve services. Same as in the domestic market, the international gold standard required on demand payment to depositors. As Bank notes weren't legal tender in this newfound international exchange, gold had to be exported if so desired by the depositor. Increases in the rate of interest "brought about by increases in the Bank rate were used to attract money to London and to prevent a drain of English reserves" (Dillard 379).

### *Instability and Failure*

The operation of the gold-standard system rested on central banks' overriding commitment to "the maintenance of external convertibility (Eichengreen 34). There was, however, a key problem with this. Not all countries had established central banks. Even in the United States Federal Reserve wasn't established until 1913. This resulted frequently in countries being forced to suspend gold convertibility to allow their currencies to depreciate properly. Yet this was just one issue.

The biggest tension and pressure associated with the gold standard was that of the role of the Bank of England. As previously mentioned, the Bank of England was operating as the steward of the gold standard, and thus British participation in the system was critical. It isn't coincidental that on two separate occasions, 1890 and 1907, Britain received foreign support when faced with inconvertibility. Yet by the turn of the century, Britain's role was "being undermined by the more rapid pace of economic growth and financial development in other countries"

(Eichengreen 42). Less of its lending returned to London in the form of foreign deposits.

Ultimately, none of these issues resulted in the death of the gold standard despite their increasingly worrisome possibilities. In July of 1914 World War I broke out, and when Europe became entrenched in the war, “gold exports were suspended in order to prevent the flight of gold...[and] moreover, the enormous increases in the quantity of paper currency and bank credit made impossible their free convertibility into gold” (Dillard 510). The reality of World War I was a complete shut down in international trade and the end of the gold standard.

### **The Interwar Period (1919-1939)**

The evolution of our modern political system has a marked discontinuity due to the outbreak of war in 1914. In an effort to be concise, I will not discuss the economics of the actual war, as it is beyond the scope of this paper. Instead, I will move on directly to the Interwar Period, which can be divided into four distinct times: Recovery and Reparations (1919-1925), the Boom (1925-1929), the Collapse (1929-1933), and Struggled Recovery (1933-1939).

#### *Recovery and Reparations (1919-1925)*

Reparation payments, territorial changes, hyperinflation, and a desire to return to gold characterized the reality of this time period. In the Armistice Convention signed on November 11, 1918, “it was agreed that Germany was to pay reparation to the victorious Allies” (Kindleberger 290). The amount of such reparations was left

undecided, but Germany was forced to sign the treaty, taking on any and all responsibility for the war. It was generally agreed upon at this time that since Germany was responsible for the war, they should be responsible after the war, meaning that they would be required to pay for it. Because of extreme differences of opinion on the Allied side about how much this should be, a special Reparations Commission was called upon. In April 1921, the Reparations Commission fixed an amount of 132 billion gold marks plus 26 percent in export taxes over a period of forty-two years (Kindleberger 290). Germans weren't happy with this arrangement as it was, but given their relative position in the world at this time, there was little that they could say. The will to pay on the side of Germany was weak, and at times, completely missing.

*Territorial Changes.* Typically, economic relations are not based on such international relations issues as territory changes. The aftermath of World War I was an exception. Germany lost approximately one-third of its coal resources, located in the key area of the Saar and Upper Silesia (Dillard 511). France, under the provisions on the Versailles Treaty, had taken over this area postwar in order to provide coal to produce steel in the Lorraine, an area taken by Germans during the war. Additionally, Germany was obligated under the Treaty to supply additional coal to France "to compensate for the war damage to coal mines (Dillard 511)." This was part of the general reparations that Germany was to pay, but the remaining coal left after such repayments wasn't enough to supply Germany's rebuilding efforts and postwar industry. Coal wasn't the only resource that Germany once had but now lacked. The Lorraine was also rich in iron ore. These postwar changes had interfered

with the production system, and the result was disorganization and loss of efficiency in the European steel industry.

In January 1922, Germans called for a conference in Cannes to discuss a potential moratorium and to reopen the reparation question. Britain had been pushing for a revised and reduced schedule, largely influenced by Keynes, and opened the conference up for the idea of an international loan to Germany. In April the Reparations Commission met to further explore this possibility, but in June, the committee decided that “given the reparation schedule, Germany’s credit was not sufficiently high to justify an international loan (Kindleberger 293).

*Hyperinflation.* Late that summer and into the following fall, Germany’s reparation payments fell completely off schedule. Germans had no way of meeting the demands placed upon them. They were lacking territory, and even more, the French didn’t want the competition of German workers taking jobs away from domestic workers in their reconstruction efforts (Mayhew 1). The situation worsened. French and Belgian troops were sent to occupy the Ruhr in an attempt to enforce reparation payment delivery. This resulted only in a strike of German workers, and in an effort to aid these workers, the German government simply began printing more money. Average wholesale prices rose “from an index of 1,400 (where prices were measured as 100 in 1913) to 126,000,000,000,000 in December of 1923” (Mayhew 1). The mark was rendered worthless and was replaced in November (after great damage to the middle class) by the Rentenmark, an entirely

new currency. The German government also raised taxes at this time. The Rentenmark was then later replaced by the Reichsmark with the Dawes Plan.

The Dawes Plan, created by an international committee of both moderates and extremists, was key for Germany. Announced in April 1924, it created a reparation schedule beginning with “1 billion gold marks for the first year, 2.5 billion in the fifth...[and] provided room for changes if gold prices moved up or down by 10 percent (Kindleberger 294). The provisions included both a Reparations Agency, established in Berlin to oversee finances, and a reorganization of the Reichsmark. Finally, and most importantly, the Dawes Plan created a provision that allowed 800 Reichsmark to be sold on various markets. Despite protests on the side of the French, the governments of both France and Belgium applied heavy pressure to private bankers to have them handle the shares of the loan. For a while, this solution seemed to work, and Germany was able to make its payments on schedule.

As it turns out, this was a deceptive reality. American private investors, particularly out of New York City, had been making large dollar loans to Germany. It was these dollars that were used to make reparation payments, which the Allies in turn used to make war debt payments (Dillard 520). War debts were “incurred for assistance and for shipment from the U.S. of grain, cotton, and other supplies during the war” (Mayhew 2). The Americans insisted on these, not from Germany, but from the Allied forces. The American government had, however, made it abundantly clear that they didn’t wish to receive repayment in the form of goods by instituting

ridiculously high tariffs. With this cycle of loans and war debt payments, the United States was essentially paying itself.

*Return to Gold.* During this interwar period, the gold standard had been largely abandoned with only United States and a few other small countries still maintaining it. The reason for this is that crucial aspect of the gold standard no longer existed: money was no longer exchangeable into gold. However, there was still a strong desire to return to the prewar system due largely to the fact that it had facilitated large amounts of international trade and globalization. So between 1923 and 1928 more than thirty nations restored the gold standard in some form (Dillard 538).

The greatest decision concerning this, however, was not whether to restore the gold standard, but rather at what level to set it. In Great Britain this debates existed over whether they should fix the pound sterling to its prewar gold content or at the existing post war value in relation to other currencies (Dillard 538). Eventually it was decided that Britain would return to the gold standard at the prewar level. They were to do this by permitting free export of gold bullion after April 1, 1925. Yet when this decision was made, the pound was nowhere as strong as it had been in the prewar years. Prewar, the pound was valued at \$4.40, but in this interwar period, it was around \$4.87 (Dillard 538). To return to gold meant that the pound would have to appreciate, and so to restore the par ratio between the dollar and pound meant that prices needed to either rise in the US or fall in the United Kingdom. Given the stability of the United States in the post WWI time

period, this fell to Britain. Essentially, in order to make the gold standard work, Great Britain would have to deflate its price levels.

The British were encouraged to then rely more heavily on imports as the British pound sterling would now buy 10 percent abroad more than before and very little more at home (Dillard 539). This led to an adverse balance of trade, but meeting this adverse balance by permitting gold to be exported was undesirable due to the low levels of gold. So the Bank of England then opted to increase the bank rate in order “to attract loans to Britain to cover the deficit in the balance of payments” (Dillard 539). This ultimately led to housing shortages, unemployment, and little construction. The British economy “did not enjoy the expansion of production that took place elsewhere” (Mayhew 3).

### *The Boom (1925-1929)*

With most countries now either on the gold standard or moving towards it, “normalcy” seemed to be restored. But this time was not without its tensions. In the time before the World War, London had been the center of the financial world, and the Bank of England was the lender of last resort. During the 1920s, however, Europe became unable to function as the world’s banker. Britain had continual difficulty of maintaining the pound at \$4.87 while high interest and unemployment rates persisted. Important to note is at the same time of this overvaluation of the pound, there was an underevaluation of the French franc, which had led to a pile up of sterling in the French monetary system (Kindleberger 354).

*Role of the United States.* In light of this, the United States stepped in to replace Britain as the world's banker by offering long-term loans. American banks lent in very large sums and these loans led to a high dependency level of Europe on the United States. At the same time, however, American economic policy "placed major obstacles in the way of repayment of loans" (Dillard 541). Having been in such a large creditor role, the United States should have increased its imports in order for foreigners to have the opportunity to earn dollars with which they could then service their debt. Lowering tariffs would have done this. The United States, however, did just the opposite. In both 1922 and 1930, tariffs reached their highest point in history. Those foreigners who had received loans paid the interest on their debts temporarily out of further loans rather than from increased productivity (Dillard 541).

The boom, however, existed because of and depended largely upon the United States, whose economy was beginning to show signs of weakening. Consumer buying was slowing, debt reached its highest level yet seen, and construction slowed considerably as the demand of new housing evaporated (Mayhew 4). These conditions on top of the high tariffs put the portion of the world that depended on the United States (which at the time was a considerable amount) in a precarious situation.

*Reparations.* Reparations were also becoming increasingly worrisome during this time. They were being financed by borrowing, but they remained difficult to maintain. Germany in particular was beginning to crack under the strain. In order to



meet the immense obligations of the reparation agreements, Germany would have to (1) build up tremendously its industrial productive capacity; (2) have exports in excess of imports by at least the amount of reparations; (3) dispose of the huge export surplus either directly to the Allies or sell in competitive world markets; (4) keep domestic consumption far below domestic production for several generations by heavy taxation (Dillard 517). Each of these proved to be ultimately impossible, and it wasn't long until Germany was no longer willing "to produce great surplus wealth for the benefit of their victorious enemies while the German struggled at or near subsistence" (Dillard 519). These deteriorating conditions led to tensions that would ultimately result in a collapse.

*Primary product inventories.* As a final note, European recovery in the production of primary products, such as grain, had led to prices to "turn soft" as early as 1925 (Kindleberger 355). This means that as inventories of such products began to grow, prices began to fall. The consequences of this had the greatest ramifications in countries such as Australia and New Zealand who depended on export of these products and for agricultural regions of the US. Essentially, the world had "more capacity to grow food than it had capacity to buy food" (Mayhew 4).

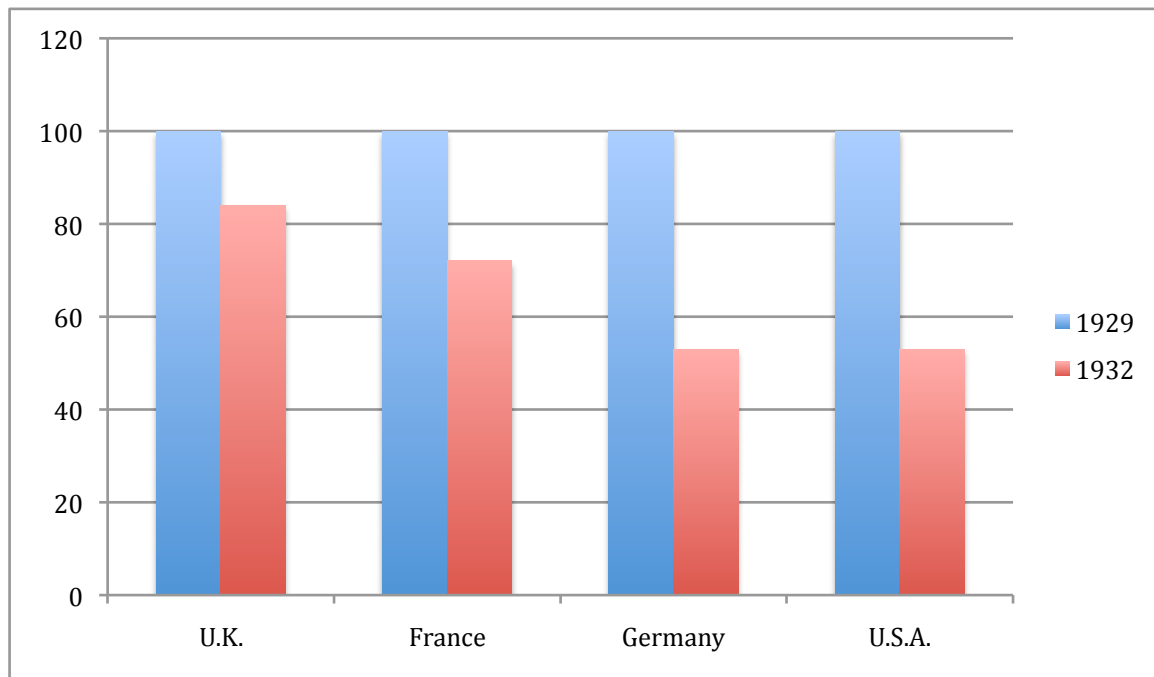
### *The Collapse (1929-1933)*

The tensions during the boom period were realized when in 1928 foreign lending from the U.S. began to drop. Schacht's campaign, an attempt against German borrowing in New York, resulted in a switch to short-term loans. Depression in Germany had started a little earlier (around 1927) and the higher interest rates

necessary to attract short-term funds pushed production still lower (Kindleberger 355). Unemployment rose exponentially, and the Frankfurt Insurance Company failed in August 1929. In the United States, the stock market, despite the Fed's best efforts, began to rise. In an effort to combat this, the Fed raised the discount rate. This Wall Street boom in U.S. stocks led to still a further drop in long-term lending. Around the same time, the Bank of France pulled gold out of London due to irritation over the Young Plan, which in turn resulted in a tighter situation in Britain. The Bank of England raised its discount rate from 5½ percent to 6½ percent on September 26, 1929. This led to pressure in Scandinavia where discount rates were also raised in an effort to keep in line with Britain. There was a certain worry at this point that Great Britain would be forced off the gold standard, but such fears were delayed with the stock market crash on October 24 and the subsequent Black Tuesday on October 29 (Kindleberger 355).

*Decline in Production.* By mid-1929 production of goods and services began to fall sharply worldwide (Mayhew 5). It became increasingly difficult to negotiate the terms on which goods could be converted into money, and soon losses replaced profits, "meaning that at the end of a turnover of capital the producers had less money than at the start of the turnover period" (Dillard 543). The goal became to conserve, not expand, and goods which could no longer be converted easily to money became "worthless," at least to the capitalistic notions of this time. This idea played out internationally in the form of gold. Credit was no longer a worthy substitute of money, and thus production halted in an effort to keep gold close to home. This led to huge declines in production and in employment. As the cycle

continued, the situation worsened. Consider the following chart (which assumes a standard production of 100 for 1929):



Mayhew, Anne. "Notes on the Interwar Economies of Western Europe."

*Departure from the Gold Standard.* As long-term American loans ended and international trade fell, debtor nations sought to borrow short term at high interest rates in an effort to cover their deficits. Such actions might have been successful if the depression had ended soon thereafter, but with the continuation of such a deep depression, the high interest rates on short-term loans just drove the depression deeper.

Panic reached new levels in the world money markets in May 1931 when the largest bank in Austria crashed due to the bad loans they had made to the agricultural regions of central Europe. This in turn caused a complete lack of confidence, and money markets began to crash all over the world. London, New

York, and Berlin were among them. Prior to this crash, it is important to note that during the early months of 1931, the Reichsbank had lost nine-tenths of its gold reserve, which had resulted in several German banks closure and a discount rate of 15 percent (Dillard 542). Germany under normal circumstances would have gone off the gold standard and allowed the currency to reach its natural level in international exchanges, but the recent hyperinflation kept this politically impossible. Instead, Germany “suspended all foreign payments and imposed rigid exchange controls” (Dillard 542).

Suspension of payments in Germany had ramifications in Britain, where British credits were now frozen and uncollectable. Depositors of the Bank of England became alarmed and began to withdraw heavily, despite the Bank of England’s efforts in raising the discount rate. Ultimately, they lost more than 200 million pounds within just two months of Germany’s foreign payment suspension (Dillard 543). The final blow came on September 20, 1931, after a week long “gold rush” where gold reserves dropped to dangerous levels. The Bank of England decided to suspend gold payments, and officially took the United Kingdom off of the gold standard. Reparations had also stopped entirely.

#### *Reaction and Recovery (1933-1939)*

Many countries quickly followed suit and took themselves off of the gold standard. By 1932, thirty-five countries had come off of the gold standard, each with different results. In the United Kingdom, there was a sigh of relief. They entered a period of mild domestic inflation, increased employment, and rising business expectations

(Dillard 544). Of the large nations, only France and the United States attempted to stay on gold, and they, in turn, suffered for it. French and American exporters found that no one wanted to buy their goods because their currency was valued much higher than others, and when they further erected high tariffs and import quotas, they sealed themselves off from world trade. They imposed on themselves “continuing deflation of domestic prices to the accompaniment of rising unemployment and still deeper depression” (Dillard 544).

The United States faced deeper problems still when foreign withdrawals coupled with increasing domestic demand for gold caused a gold crisis due to the lack of credit (Dillard 544). Bank runs became increasingly more common, and in turn, the hoarding of gold led to a liquidity crisis. When more than 5000 banks failed in two years, the United States temporarily closed all banks in March of 1933. Soon thereafter, the U.S. suspended gold and was forced off the gold standard. France collapsed soon afterward, an action which would result in a decade of moderately inefficiency on the part of the French government. So with France and the United States now officially off gold, the gold standard and international trade crumpled.

Around this time the Nazis, however, were beginning an active program of recovery to a depressed Germany. The unemployed were put to work building up domestic infrastructure. Under the second Four-Year Plan, beginning in 1937, rearmament became the most important aspect of German policy. By 1938, Germany’s industrial production had more than doubled its 1932 output (Dillard 558). The economy during World War II is beyond the scope of this paper, but let it

suffice to say that the Germans gave an incredible economic performance during the war. The aftermath, however, left Europe once again in ruins.

### **The Bretton Woods Era (1944-1971)**

In an effort to keep this history concise, I will not be discussing the wartime economy, as it within itself had no direct effect on the evolution of the international monetary system. I will instead move directly to the post-war period, which began in 1944. The Bretton Woods Era can be divided into three subperiods:

Preconvertibility (1944-1958), the Prime Years (1959-1967), and the Collapse (1968-1971). Before exploring each of these, I will first discuss the vision of the architects of Bretton Woods, as it is a telling statement of the mentality of the period.

#### *The Vision of the Bretton Woods Architects*

The situation directly following the war and the experience of the previous monetary times had a direct effect on the ideas about a new international monetary order. The original goal of the Bretton Woods system was to combine the advantages of the classical gold standard with the advantages of floating rates. At the same time, the planning of a new international order was predicated on the belief that the mistakes of the interwar period were to be avoided. Europe was also struggling with the recovery from the devastation of the war, and having just come off a time of two world wars, the international community sought a system that would promote peace and interdependence.

World War II resulted in power shifts that in turn slanted discussions of the creation of a new system. The United States had emerged from the war as the strongest and richest power in the world, but Great Britain had been severely weakened (Bordo 31). Against the backdrop of wartime diplomatic negotiations, these two countries agreed to be of assistance to each other in the post-war world. John Maynard Keynes of the British Treasury and Harry Dexter White of the American Federal Reserve each drafted two plans of what they believed the post-war economy should look like. A compromise between these two plans, following a period of tough negotiations, led to the *Joint Statement by Experts on the Establishment of an International Monetary Fund*, which in turn served as the working draft at the Bretton Woods conference and led directly to the *Articles of Agreement of the International Monetary Fund*. Along with the IMF, Bretton Woods also created the World Bank.

*The Articles of Agreement.* The Articles of Agreement was a compromise and incorporated aspects of both plans, but ultimately, due to its new world power status, the United States dominated the concerns. The objectives of the fund were “to promote international monetary cooperation, to facilitate the maintenance of full employment and rapid growth, to prove a multilateral payments system and eliminate exchange restrictions, to provide resources to meet balance of payments disequilibria, and to shorten the duration and lessen the degree of payments disequilibria” (Bordo 35).

The method that this system was to work was threefold. First, all currencies were to be treated as equal in the articles. Ideally, each country was required to maintain its par value by intervening in the currency of every other currency, but in reality, the United States was the only country that pegged its currency (in terms of gold). The others simply fixed their currency in terms of the dollar and intervened only to keep their exchange rates within 1% of parity with the dollar (Bordo 37). Second, countries would use their reserves or draw reserves from the Fund to finance payments deficits. Third, capital controls were required to prevent destabilizing speculation from forcing member to alter their parities prematurely or unintentionally (Bordo 37). In the end, however, the goals of Bretton Woods real in many ways not realized, and the international monetary system evolved into a gold dollar standard.

#### *Preconvertibility (1946-1958)*

Reparations, which were one of the most difficult problems in post-WWI, were mostly eliminated after World War II (Kindleberger 413). Yet even still the transition to full convertibility was much more difficult than had been previously thought. This can be attributed initially to two interrelated problems: bilateralism and the dollar shortage.

*Bilateralism.* During the war, many countries had utilized a system of exchange controls, which was a technique used to regulate international trade and capital movements. Governments would require such actions as requiring exporters to surrender the foreign money received from sales abroad and requiring importers



to purchase foreign exchange from authorized banks (Dillard 546). Such controls tended to promote bilateral arrangements in foreign trade. The motto was “if we buy from you, you must agree to buy from us” (Dillard 547). Nearly all European countries used this system.

With the creation of a new international order, the goal was to eventually eliminate these. Under Article XIV of the Bretton Woods agreement, “countries could continue to use exchange controls for an indefinite transition period after the establishment of the IMF of 1 March 1947” (Bordo 38). The rationale given for continuing these during this transition period was the shortage of international reserves. Controls were needed to allocate a shortage of both imports and exports. Asian and European economies were in ruins after the war, and in order to increase their export capabilities, they needed new and improved capital. At the same time, there was a shortage of imports in everything from capital equipment to the necessities of life (i.e. food). The bilateral agreements helped create a temporary system of licenses and quotas for imports and exports through the central bank.

*The Dollar Shortage.* Europe’s postwar balance-of-payments crisis came about due to the breakdown of the international financial system. Reasons include the strength of the United States, the European liquidation of foreign investments early in the war, the cutoff to Europe’s chief source of prewar dollar supply in southeast Asia, increases in population in underdeveloped areas, the rise of prices of the primary product imported relative to prices of the manufactured goods exported, and the split between Eastern and Western Europe (Dillard 657-648). The

shortened version being that Europe had for years been dependent upon external markets for exports and foreign sources of supply for food and raw materials, and it was argued that the balance of payments deficits facing most countries reflected the incapacity of their export industries (Dillard 645). Since at this time, the United States held two-thirds of the world's monetary gold stock, they supplied the needed imports (Bordo 38). The IMF was also pressuring members to declare par values. Many believed this situation to be permanent due to the large amount of reserves in the United States and the depleted amount in Europe. Such arguments were based on the idea that Europe would never reach the rate of productivity of that of the United States.

Such a situation was not preferable for either Europe or the United States. In order to achieve a strong international system and restore Europe's equilibrium in international payments, the United States implemented the Marshall Plan. Shortly thereafter, a European Payments Union was formed, dollar convertibility was restored, and the dollar became the key currency.

*The Marshall Plan.* In an effort to aid Europe, the American Secretary of State, George C. Marshall, proposed a bold plan to restore Europe's equilibrium through "massive American financing and intra-European planning" (Dillard 648). All European nations, with the exception of Germany and Spain, were invited to join the conference, at which the logistics of the plan would be worked out. It was well received in Western Europe, but in Eastern Europe, they snubbed the idea, largely due to Soviet influence. Thus, it became a western European Recovery Plan, whose

main goal was “to coordinate the recovery efforts of seventeen countries and finance their dollar needs (Dillard 649).

The United States passed the Economic Cooperation Act of 1948, which officially created the Marshall Plan. In order to administer the plan from the American side, the Economic Cooperation Administration (ECA) was created. The Marshall Plan channeled about \$13 billion in aid to Western Europe between 1948 and 1952 (Bordo 41). This was considerably less than the projected outlays of 17 billion (Dillard 649). Its purpose was to “help the European countries expand their economies, restore their export capacity, and by creating economic stability, preserve political stability” (Bordo 41). It required that all participants cooperate in trade and payment liberalization.

Thus, a European counterpart to the ECA was needed, and in response to this need the Organization for European Economic Cooperation (OEEC) was created. Its responsibility was to create a program for achieving a balance of international payments within the four years allocated in the Marshall Plan (Dillard 649). It managed the allocation of the borrowed monies to the individual nations, which was done based on size of their account deficits. The recipients were required to then match the funds in their local currency to help in productivity investment in infrastructure, industry, and agriculture. As a final overarching goal, the OEEC tried to promote economic interdependence within Western Europe, an idea that would take on more credit at a later date. The EPU was also created on the European side, which is an organization I will discuss in more detail later.

The Marshall Plan was incredibly successful in a very short amount of time. By 1952, the OEEC countries had achieved a 39% increase in industrial production, a doubling of exports, an increase in imports by one-third, and a current account surplus (Bordo 42). The chart below shows industrial recovery in Western Europe from 1938 until 1950. It starts at base point 100.

<i>COUNTRY</i>	<i>1938</i>	<i>1947</i>	<i>1948</i>	<i>1949</i>	<i>1950</i>
Belgium	100	106	114	116	120
France	100	92	108	118	121
Germany, West	100	33	50	75	96
Italy	100	86	91	96	109
Netherlands	100	95	113	127	139
United Kingdom	100	115	128	137	150
<b>Average</b>	100	88	101	111	122

Dillard, Dudley. "Industrial Recovery in Western Europe."

*European Payments Union.* Europe responded to the ECA requirement of the liberalization of trade by creating the European Payments Union (EPU) in September 1950. Its purpose was to simplify bilateral clearing and move towards multilateralism, which it did by acting the part of a commercial bank clearinghouse. Meaning that it provided each member country with only one single net credit or

debit with the EPU. Credits earned by selling to one European member of the EPU could offset debits incurred in buying from some other member (Dillard 649). The former operation of bilateral agreements was suppressed, as it doesn't function as well with an economical allocation of resources. The ECA contributed \$350 million to the EPU to be used for initial working capital.

The EPU was incredibly successful and soon became the center of a "worldwide multilateral settlement area" (Bordo 43). It also provided the middle step toward currency convertibility. European currency at this time was not easily transferrable into dollar due to the persistent dollar shortage. So while this organization fostered intra-European trade, international world trade, particularly with those nations pegged to the dollar, was difficult.

*Restoring Convertibility and the Rise of the Dollar.* Depreciation of the pound sterling, the Deutschemmark, and several other currencies against the dollar in September 1949 helped many European currencies move towards convertibility. At the end of the 1950s, the final step was taken. President Charles de Gaulle (France) depreciated the franc and shifted to the "new franc" (Kindleberger 430). Britain took this opportunity to restore the pound to convertibility. On December 27, 1958, eight countries declared their currencies convertible for account transactions (Bordo 43). With this new convertibility, the EPU was no longer useful, and the European Monetary Arrangement would soon replace the EPU as a means of currency consultation.

So with this, the dollar became the currency of choice, and it was frequently thought that the dollar was “as good as gold.” The rise of the dollar can be attributed to the size of the role of the United States in this new world economy, its importance in world trade, and its open capital markets (Bordo 47). The dollar was the official international money of this time, and it is important to note the similarities between this and the gold standard. Instead of pegging currencies to gold, countries pegged them to the dollar, and it was no longer Great Britain as the financial center of the world, but the United States. These key points are important to remember and will shape the remainder of the history of the international monetary system. It is also important to note that the original vision of the architects at the Bretton Woods Conference was not met. The original role of the IMF had been, in many ways, replaced by the EPU. With convertibility restored, however, the system seemed to be operating smoothly.

### *The Prime Years (1959-1967)*

One of the most important events to happen during the prime years of Bretton Woods was the economic integration of Europe. Additionally, there was a series of issues, which would lead to an even further deviation from the original goals of the Bretton Woods architects. These were adjustment, liquidity, and confidence. In this section, I will first explore the beginnings of European economic integration, and then move to discuss these problems that plagued this “heyday” era.

*European Integration under the Common Market.* The idea of European integration had been around for many years, but with the new political spheres after

the second World War, the possibility became reality. The most important predecessor of the European Common Market was the European Coal and Steel Community. It was established in 1952 by France, Germany, Italy, Belgium, the Netherlands, and Luxembourg. The objective set forth was “the most rational distribution of production at the highest level of productivity” (Dillard 654).” They did so originally by abolishing all customs and trade barriers among the nations. Tariffs at the borders were made uniform, and ownership of facilities in any of the nations could be made public or private (Dillard 654). Politically, the union faced difficulties, most adamantly that between the old rivalries of Germany and France. These political discourses are beyond the scope of this paper, but let it suffice to say that the economic integration lent a peace to the countries that had yet to be experienced.

This experiment then led to the European Economic Community (EEC), also known as the Common Market. It included the original six members of the European Coal and Steel Community, but broadened its scope beyond coal and steel. The main purposes were the eliminations of customs, duties, and quantitative restrictions on imports and exports; a common external tariff to the rest of the world; the free movement of production factors within the six countries; and a general close economic integration through domestic policies, including agriculture, employment, and taxation (Dillard 565).

The Treaty of Rome solidified these economic goals, and while it didn’t specifically provide for political integration, it did provide the political institutions

for implementing economic policies. These institutions include the European Commission, a Council of Ministers, an Assembly (the modern day Parliament), and a Court of Justice. These created the modern day Brussels and helped facilitate a later political integration.

*Problems of the Prime Years.* The three problems of adjustment, liquidity, and confidence were all interconnected. The United States was not overly concerned with its balance of payments in the 1950s. The current account balance was positive, and the excess liquidity and lending of the early 1950s led to a strong confidence in the dollar by the end of the 1950s. This confidence, however, was beginning to ebb. Economists began to worry what would happen when the United States corrected its liquidity deficit. By this, they mean that in the United States, no account was taken of U.S. short-term or long-term claims on the rest of the world. It was implicitly assumed “that foreign claims on the dollar were likely to be encashed momentarily, while U.S. short-term assets were illiquid” (Kindleberger 453). This is problematic because under a liquidity definition, the United States had been in a balance of payments deficit as early as 1951.

Many argued that the ideal solution was replacing both gold and dollars with Special Drawing Rights from the IMF. Others still argued that this balance of payments was misleading. They said that “banking centers were not in deficit when they lent long and borrowed short, providing liquidity to the rest of the world” (Kindleberger 453). This would mean that the United States itself was acting as a bank and that banks were not in disequilibrium when their deposits rose each year



along with their loans. Overall, these were both overly optimistic ideas. In order for this to operate effectively, banks would need a parallel rise of reserves along with their increases in loans and deposits.

Given the loss the confidence, this gold didn't result in a rise of reserves, but instead was sold to hoarders. Central banks took additions to reserves and even, at some points, were converting the dollars into gold. Central banks across Europe, and the world, withdrew from the gold pool in 1960 to hold down the price of gold. The French government took particular action. They opted to "convert dollars into gold as a means of disciplining the United States" (Kindleberger 453). This worked until they found themselves in dire need of dollars as a means to support the franc. Yet they were still hesitant to sell gold for dollars, so instead they undertook official borrowing of dollars in the Eurobond market.

### *The Collapse (1968-1971)*

In the United States, it was decided that the ideal action would be to break up the gold pool and adopt a two-tier system for gold. This permitted the private price to rise about the official \$35.00 an ounce. At the same time, strong foreign pressure was exerted against foreign central bank changing dollars for gold, and "a number of financial instruments with exchange guarantees were made available by the U.S. Treasury to official dollar holders to forestall gold purchases" (Kindleberger 453). The United States was facing a serious loss of confidence that threatened to undermine the entire system.

Comparable to the summer of 1931 the small countries of Europe went ahead with the converting of dollars to gold. This in turn led to the Connolly shock of August 1971, which then led to the secretary of the treasury imposing a 10 percent import surtax in an effort to devalue the currency. The United States first raised the gold price then to \$38.00 and then to \$42.50, and it also widened its permissible range of fluctuation against the dollar from 1.5% to 2.25%.

Errors in monetary policy and also the enormous outflow of dollars to the Eurocurrency market in 1970 contributed to the breakdown of Bretton Woods as well. Richard Nixon's reelection campaign had his economists very anxious about creating a prosperous economy by 1972. To this end, the Federal Reserve system in 1970 started to lower interest rates. This happened at the same time, however, that the Bundesbank of Germany was seeking to restrict inflation in West Germany. They did so by raising their interest rate. These policies weren't separated by geographic region, but were instead interconnected through the Eurodollar market. The resulting flow of dollars ultimately left the liquidity definition balance of payments deficit in the United States at a much higher rate. It, in fact, rose from a "\$2-4 billion a year average in the 1960s to a \$20 billion in 1970 and a \$30 billion in 1971" (Kindleberger 454).

None of the measures taken could combat the events unfolding. The confidence in the dollar had fallen to an all time low. These pressures eventually caused President Nixon to end all gold convertability on August 15, 1971. This

effectively ended the Bretton Woods era. Several attempts were made to fix the system in the next few years but without any success.

### **The Dirty Float (1971-present)**

The recent years have been marked by severe crises and uneven monetary policy. Many of these specifics are beyond the scope of this paper, but I will instead give a brief overview. In February of 1973, the currency was set free to float. This means that no longer was currency pegged to gold, but instead the exchange rates against other currencies were allowed to be determined by the market. Many economists were surprised by its effects. Many thought that it would do the same as it had in the 1930s, and that flexible exchange rates would inhibit capital flows because of the uncertainty of exchange risk. This turned out to not be the case. If one needed a substantial amount of capital, it was necessary to borrow dollars (Kindleberger 455). Quantity turned out to be more important than quality.

Economists also thought that the floating dollar would lose its preeminence and its role of the international unit of account, standard deferred payment, store of value, and means of payments. Again, these predictions were proved to be wrong. It was perhaps not as strong as it had been in the past, but in the immediate aftermath of floating exchange rates, the dollar still maintained its role. The SDR of the IMF, which was previously mentioned, never was seen as satisfactory alternative, and never gained any position in the international monetary system.

At the same time, however, this period did begin a time of severe crises and monetary upheaval. It is important to note that European dependence on the dollar

had been well noted by the Europeans after the collapse of the Bretton Woods era. After this series of events, the European idea of a currency (the Euro) began to really formulate. The European Monetary system was based largely on German fiscal sense, a fact that will become increasingly important in later years, and will be discussed at a later point.

It's also important to note that world banks, which were full of new funds, after the balance of payments problem in the United States, started to look for new opportunities to lend. This initiated the boom in syndicated bank loans to sovereign states, especially in Latin America. The boom in lending went unnoticed through the 1970s. Bankers trusted that these developing countries would not repudiate on their loans. This awakening occurred in August 1982 for the first time when Mexico failed to make its interest payment.

*Conclusions from the Dirty Float.* Overall the inability of the international monetary system to reconstruct a system of pegged but adjustable exchange rates failed repeatedly. The source of the failure was the ineluctable rise in international capital mobility, which made "currency pegs more fragile and periodic adjustments more difficult" (Eichengreen 183). Growing numbers of governments found themselves forced to float their currencies due to the "heightened reluctance of their strong-currency counterparts to provide support" (Eichengreen 183).

Developing countries in particular have suffered. They found it very difficult in these thin financial markets to endure the volatile effects of rapid exchange rate fluctuations. Even Europe and the United States have felt the effects. The European

market efforts were interrupted at various times due to this. Even the United States and Japan temporarily lost faith in the ability of the markets to drive their bilateral exchange rates to “appropriate levels in the absence of foreign exchange market intervention” (Eichengreen 184). Such dissatisfactions led to a variety of partial measures to limit currency fluctuations

### **The Fluctuations of the 1990s**

The 1990s were a highly turbulent time of global imbalances and financial crises. In order to understand the volatility of today, it is first necessary to understand the transitional period. In this section I will briefly examine the Asian financial crisis and the Euro. These sections will not necessarily be an historical background section, but will instead focus on how they directly relate the instability of the system today and highlight its need for change. After examining the transitional period of these times, I will then move to an entirely new section, which will examine the current situation.

*The Asian Financial Crisis.* Asia had for a long time seemed very insulated from the exchange rate volatility that was affecting the rest of the world. Strong governments, capital controls, and rapid growth led by exports kept confidence high in the region. The remarkable part of this crisis is that the Asian crisis occurred despite these securities.

Foreign investment was highly favored in Asia due to this strong economic record. Yet capital was flowing to troubled countries like the Phillipines, which indicated that additional factors were at play. The most important of these were the

low interest rates in the major financial centers. The cost of borrowing in yen fell to low levels as a result of “depressed conditions in Japan, while yield on investment in the United States were depressed by a soaring stock market” (Eichengreen 1992). Investors turned to these emerging markets as a means of relief by borrowing in yen and dollars to invest in such high yielding Asian securities as the carry trade. It is important to note that banks were used as an instrument of economic development in Asia at this time. Foreign investors used this to their advantage and lent extensively to Asian banks, all the time believing that they would not be allowed to fail. The important thing to take away here is that not for the first time, global conditions helped set the stage for problems.

The area was also plagued with an inconsistency of capital-account policy, exchange-rate policy, and political instability. The region had large and unmanageable capital flows and relaxed banking regulations. At the same time, governments also opened the capital account before moving to a more flexible exchange rate. Economic theory and history itself dictates against this.

Against this backdrop the crisis hit with a series of shocks. It began in Thailand with the financial collapse of the Thai baht. This was caused by the decision of the Thai government to float the baht and cut its peg to the dollar. The government had in the past overextended itself in an effort to support it and could no longer afford to do so. Thailand had also acquired a large amount of foreign debt, which essentially bankrupted the country even before its currency collapsed. The IMF had warned the Thai government that its currency was severely overvalued, but

it continued along its path of destruction. The Thai collapse was no small surprise to the international community. The surprise came later when other Asian countries followed its lead.

Pressure was immediately felt in the Philippines, a country that was ultimately not stable to begin with. The country was highly dependent upon capital inflows and had a very rigid dollar peg (keep in mind that at this time most countries were no longer pegged to the dollar). The Philippine authorities decided to float the peso only ten days after the baht. This then put pressure on Indonesia and Malaysia, where investors there really began to face a confidence crisis. Korea also faced a panic, but the G7 helped stop this crisis by convincing international banks to extend short term loans to Korea in an effort to renew their credits and effectively buying time for the government to put reforms in place. Indonesia, however, faced a complete banking and financial system failure, resulting in a disruption in production and a painful recession. Only China remained immune.

The crisis highlights just how volatile the markets are and how contagion can spread throughout a region. The crisis caused sharp drops in output all across Asia. A variety of reforms resulted from the crisis, including currency devaluation, recapitalized and restructured banks, and enhanced lending procedures. Even today, some of these economies have not recovered to their pre-crisis state of production. Yet one interesting initiative that came out of the crisis was the Chiang Mai Initiative, or CMI. Under this agreement, Asian central banks agreed to provide financial support for their neighbors in the same way of the European Monetary

Ssystem. The goal was that next time a country suffered a capital flow reversal and its currency came under attack, official funding would be available to replace private funding (Eichengreen 197). The problem with such a system is that governments are often unwilling to lend without assurances, as I will discuss in more detail and in a different capacity at a later time.

Asia is not the only place we have seen such crises and volatility. The role of the exchange rate and the false sense of security is remarkably similar in other emerging market crisis. Each national context is unique of course, but Argentina, Brazil, and Turkey have all experienced high inflation “rooted in large budget deficits and compounded by structural problems” (Eichengreen 199).

*The Euro.* After the collapse of Bretton Woods, the need and desire for a European currency was increased. Despite early financial problems, Europe was set on this course since the early 1990s. The United Kingdom and Denmark dropped out of the process early on, but the others persisted and the Maastricht Treaty was formed. At German insistence, the Treaty set targets for inflation, interest rates, exchange rate stability, and fiscal stability for countries seeking to qualify for participation in the union. Fiscal criteria was set at a budget deficit of not more than 3 percent of GDP and a public debt of not more than 60 percent. These were insisted upon most stringently. The idea behind it was to prevent weak economic countries from entering and possibly endangering the entire system.

The changeover from domestic currency to this supranational currency was planned with excruciating detail. The original monetary union was very small and



centered on France and Germany. Yet the final plan was much larger than planned and included countries such as Ireland, Italy, Spain and Portugal, who had not always had the strongest financials. Despite this, there was to be a European Central Bank and a Stability Pact that was designed to provide continued oversight of national budgets. The prospective members of the euro area agreed that “they would irrevocably lock their exchange rates as of January 1999 at the same level prevailing in mid-1998” (Eichengreen 221). The changeover was completed at the beginning of 2002.

The euro was weak against the dollar for its first few years, and many complained that the central bank was too tight on its requirements. Despite this, the monetary union ran smoothly and seemingly created a sense of “Europeanness” that had yet to be seen, despite the efforts of the Union itself, formed over 40 years before. The euro ultimately in the coming years enhanced price transparency, encouraged cross border trade, and created a currency to eventually rival the dollar. It seemed almost too good to be true, and as recent events highlight,

### **The Current Situation**

Since 1971, the world has been in a period of floating exchange rates, which in turn has led to high levels of instability and increased financial crises. In order to illustrate this, I will examine two troubling current events in our monetary system: the current crisis in the Euro zone concerning government debt in Greece and the Chinese holding of U.S. Treasury debt. Together these two events highlight the need

for change and underline the current problems facing our system. I will do this through economic analysis of current newspaper articles.

*Germany and Greece: Struggles in the Euro zone*

European enlargement has been a challenge plaguing Europe for the past 50 years. Since the 1958 Treaty of Rome, which established the European Economic Community, Europe has taken leaps and bounds towards their goal of full political and economic integration. The recent crisis in the Euro zone, which is the 16 countries within the European Union that operate with the Euro as their currency, has highlighted the single most important problem they have always faced: the absence of a single government. The euro zone is not an “optimal currency area,” and thus it lacks the important tools to deal with asymmetric shocks, meaning shocks that affect some members more than others. In this sense, I mean tools to be a “treasury with powers to tax and borrow and a central bank that can act as lender-of-last resort to member banks” (Skidelsky 1). So in an effort to illustrate this problem, I will first analyze the coming of this crisis, the Greek situation, the German response, the possibilities and ramifications of IMF involvement, and finally what this means for the world as a whole.

*The Encroaching Crisis.* The European Monetary Union, which formed the basis of the euro zone, began with grand ideas and plans. There were countries such as Austria, Finland, the Netherlands, and Germany who had strong currencies domestically and internationally, but there were also countries such as France, Belgium, Italy, Portugal, Spain, Greece, and Italy, whose currencies were consistently

depreciating and did not maintain a high value internationally. Such a situation created a natural inequality, but the European integrators insisted and the union was devised as “one-size-fits-all” (Sorkin 1).

The criteria to enter the union were strict, due largely to the German influence, and many of these countries with depreciating currencies were unable to fit the criteria to enter the union. Instead, they relied on what has come to be known as “creative accounting,” and some countries, for example Greece, even went so far as to “falsify its debt and deficit numbers” (Sorkin 1). In the beginning, however, this didn’t pose much of a problem. The union itself is made up of 27 countries and has formed what many called the “world’s most formidable economic bloc, incorporating 491 people in an integrated market that produces nearly a third more than the United States” (Erlanger 1). Granted, the union had its issues, but they weathered the storm in admirable fashion. It wasn’t until the 2008 financial crisis that the cracks began to show.

Before beginning the discussion of the crisis itself it is important to recognize that the central tension in the European Union has always been between national priorities and central interests (Erlanger 2). The idea of “European” has never been as strong as nationalism, and the idea of ceding national powers with everything from currency to customs has never been an easy one to deal with. When crises or panics hit, the automatic reaction is to turn national by protecting their own resources and industries. While this hasn’t delayed integration up to this point, it has recently begun a “scaling down” of ambitions (Erlanger 2).

*The Greek Situation.* These mounting tensions have been realized in the Greek economy recently. As previously mentioned, Greece bent the rules of the euro zone in an effort to be admitted, and all the years of “unrestrained spending, cheap lending, and a failure to implement any financial reforms” have caught up with them. In early 2010, the idea and fear of a sovereign debt crisis really began to develop in many troubled euro zone countries, including Spain and Portugal, but the crisis developed most fully in Greece. The crisis then led to a confidence problem, which as shown in the background section has caused serious problems in our monetary system in the past, and this was no exception. It also led to the widening of bond yield spreads and risk insurance on credit default swaps within the euro zone. The situation was further worsened when a 500 million government bond auction in Portugal failed to raise that amount. Instead of the 500 million, the Portuguese government only successfully raised 300 million. Panic ensued, and these fears combined to a weakened euro and a widespread global commodity selloff.

With this situation in the world, Greece’s debt and fiscal issues came to light. National debt is said to be at around 300 billion, which is larger than the nation’s economy itself. Some economists are predicting that the debt will reach “120 percent of gross domestic product in 2010” (CNN 1). The country’s deficit, meaning how much more it spends than it takes in, is at 12.7 percent. These numbers are incredibly high and well beyond the bounds of the euro zone. In response, Greece’s credit rating has been downgraded and is now among the lowest of all members of the euro zone. This doesn’t bode well for Greece, as it is now a “financial black hole”

to all foreign investors (CNN 1). The country is struggling to pay off these debts and to make good on their current bills, but it's difficult considering that interest rates are rising on the existing debts. The Greek government has responded through Prime Minister George Papandreou by implementing spending cuts, an act which is incredibly unpopular among the Greek populace. They have also implemented austerity measures aimed at reducing the deficit by more than 10 billion euro. Taxes have been increased on such products such as tobacco and alcohol, the retirement age has been raised, public sector pay cuts have ensued, and tax evasion regulations have been strengthened (CNN 2). Liquidity is a major issue in Greece currently, and these domestic actions won't be enough. Greece alone cannot pull itself out of this financial hole.

*The Euro Zone Response.* In an April 9, 2010 article, CNN wrote that Greece is "in danger of defaulting on its national debt as its bond market comes under increasing pressure, unless its European neighbors intervene" (Smith 1). This statement sums up the thoughts held not only across Europe but also across the globe. The pressure, however, doesn't fall upon either of these, but instead on the members of the euro zone, specifically Germany. Greece's finance minister has said that "yield of almost 7 percent [on these bonds] are high enough to give investors a good return for the risk involved" (Sorkin 2). But even as this was said, the Greek government, as highlighted above, was raising half of its funding requirement of 53 billion Euros throughout the spring. In a market such as the prevailing one, this isn't good.

Originally, the European Union set out with a challenge to the relatively weak governments to impose high taxes and spending cuts, which Greece, as stated above, did. The action, however, proved to not be enough to get their deficits down from “over 10 percent of GDP to the benchmark levels close to 3 percent of GDP as called for in the European treaty that created the euro (Sorkin 2). Joseph Stiglitz, an economist and current advisor to Greece, pointed out the hypocrisy of the situation here. Richer countries in Europe has been allowed to borrow heavily to pull themselves out of recession, but the poorer countries were forced to “take a knife to the very programs intended to soften the blow of an economic downturn” (Sorkin 2). Instead of taking care of the solution domestically Stiglitz proposes that Europe’s richest countries, such as Germany and France, take the lead in aiding Greece.

Stiglitz’s advice would eventually be taken to heart, but not without much debate. After a full two months of discussion, the European Union unveiled the details of its Greek financial rescue plan on April 11<sup>th</sup>. Its involved the 16 euro zone members, and offered Greece up to 30 billion Euros in bilateral loans in the first year, with more available in subsequent years. Interest rates were to be set around 5% for three-year loans initially. The number was a compromise between the small rates that the markets are demanding and the interest rates being paid by the weakest members of euro zone, like Portugal or Spain. The members of the euro zone are remaining firm that this is not a bail out, and that the “no bail out” clause should remain in tact. They do this by stating that “the loans are repayable and contain no element of subsidy (The Skies Brighten 2).

Of all the countries of the euro zone, Germany will contribute the most, an action that came to pass after considerable resistance. Angela Merkel, the German chancellor, led a tough resistance to the idea of the bailout. Merkel was backed by both Austria and the Netherlands. In Brussels, the EU governance agreed that “the euro zone stands by its founding principle that profligate members cannot be bailed out, but that Greece would also not be allowed to fall victim to a sovereign credit crunch” (The Skies Brighten 2). Ultimately, Germany, with the current account surplus, decided to contribute to the European project, if only due to the close financial ties between the countries. German banks hold large amounts of Greek government debt and in the event of a Greek default would suffer largely (The Skies Brighten 2).

The bailout plan is being offered as a last resort, and aside from the bilateral loans, the IMF has offered funds and technical assistance. The details of IMF involvement will be detailed in the next section.

*IMF Involvement.* The Greek bailout involves funds from both internal sources and also the IMF. IMF involvement was heavily pushed by Angela Merkel, who was eager to show Germany that “their country would not have to foot the entire bill to help Greece” (EU approves 1). Not all were as excited over “substantial International Monetary Fund financing,” however, as the Germans (1). EU leaders had been hesitant up to this point over involving the Fund, as they weren’t technically “European.” IMF involvement could weaken the euro further, resulting in its fall against other currencies.

Despite the risk, the IMF is prepared to lend Greece around 10 billion Euros. European Union nations outside of the euro zone, such as Hungary and Romania, have all received support from the IMF, which then promptly “imposed various fiscal requirements intended to insure they can pay back the loans” (Sorkin 3). The difference now is the euro zone boundary, and IMF involvement makes the EU look weak. Miranda Xafa, a former executive board of the IMF, makes a good point, however. She believes that “the time has come for Europe to acknowledge that it has neither the technical expertise to monitor government behavior nor the ability to raise rescue funds” (Sorkin 3). It is believed by the IMF that their involvement would help the other countries and restore confidence. In Brussels, the view is the exact opposite.

*What This Means for the Future of Europe and the World as a Whole.* For Greece, the bailout was a necessary action. It could not have alleviated its debt without some form of involvement from either the IMF or the European Union. In recent days Greece has continued to struggle. Market anxiety has pushed Greece’s long-term bond yields to “their highest levels since the country joined the single currency nearly a decade ago” (The Skies Brighten 2). Fitch, a credit-rating agency also downgraded the country’s debt by two notches to the lowest investment grade, one grade above “junk” status. Fitch has also recently cast doubt on the Greek government’s political vows to cut the public deficit by a third this year. Essentially, the recession is deepening and the costs of servicing their high debt are increasing. So, as I see it, it is only a matter of time before Greece must implement the European rescue mechanism. Once Greece has decided that there is nothing more they can do



domestically, officials from the European Central Bank and the European Commission “must agree that Greece is out of options” (The Skies Brighten 3). Once this decision is made, the euro zone will be whipped into a frenzy of action, as things are predicted to move very fast.

For the euro zone, this has placed tension on the internal relationships. Germany, in their reluctance to aid, is turning ever more inward domestically. As they have since the hyperinflation always been very fiscally sound, such irresponsibility financially doesn't urge the type of international cooperation and integration that is promoted by the treaties of the European Union.

As this is the first time this has happened, Germany did provide the relief that Greece needed. What happens, however, if this happens again and soon? The Greek crisis could be only the first of predicted multiple tremors. The confines of the euro zone have created problems. If Greece had been outside the euro zone, for example, it could “devalue its currency to make it more competitive, and its foreign debts could be renegotiated in an international conference (Starbatty 1). Instead, we have entered into a sovereign debt crisis with the strongest currency in the world threatening to plummet. Spain and Portugal aren't far behind Greece is their relative weakness. Italy is also a concern as it is the third largest sovereign debtor. If it comes to pass that these countries also need a bailout, and Germany and France are supposed to provide, who then will rescue the rescuers?

In an effort to keep these crises from happening again, The European Commission is discussing giving the EU executive powers to “recommend economic

overhaul programs to individuals countries, and to name and shame laggards by sending warnings in cases of inadequate responses” (Taylor 2). On the outside, this is a solid plan, but in the realities of the euro zone, countries don’t want to cede authority to a larger supranational body. Germany as the biggest European economy, has “made it clear that it does not want EU scrutiny of its own export oriented policies, which generate big current account surpluses that economists say are partly responsible for widening imbalances in the euro zone” (Taylor 2).

Furthermore, it has been suggested that the EU needs to create a European monetary fund whose function is to operate like an IMF style assistance program, but only for euro countries in fiscal danger. Yet, this runs against the founding ideas of the European Union. The treaties of the EU forbid such bail out actions, and as the recent Lisbon treaty has shown, it is not easy to get changes to treaties passed in Europe.

At the same time, should Greece default on its loans and a chain of bank insolvencies ensue, perhaps the European Union would be made stronger. Nations often come together in times of crisis, and a hit on the Euro would certainly qualify as a crisis in this sense. This seems overly optimistic, however, as the trend in Europe has for years been to veer towards national interests in times of crisis. Despite all of this, it is unlikely that any country would leave the euro zone. The effects are nationalized and therefore beyond the scope of this paper, but let it suffice to say that these effects would be disastrous and enormous for the country that opted to do so.

Overall, the Greek economy, as I see it, will be eventually bailed out by the plan created by the Europeans and the IMF. IMF involvement is crucial as it shows the continued usage of the institution. When implementing any potential reform, it is necessary to keep this idea of an international lender of last resort at the forefront. It provides a degree of stability and equalization in this highly globalized world. The effects and possibilities of the Greek bailout are still unfolding, as the crisis is ongoing. Regardless of what happens, however, it highlights a deeper problem within the international monetary system. If the Euro were to fail, it would cause tremors across the globe. If the euro is to make it, then will it soon replace the dollar as the primary currency? All of these questions are unanswerable now, but they bear scrutiny when discussing the forming of a new international monetary system.

#### *China and the United States: Tough Economic Relations*

Europe isn't the only country facing a form of debt crisis. The United States has a very large public debt (of which it is not alone). Yet this in and of itself isn't concerning. The concerning factor is that around twenty five percent of this debt is in the hands of foreign investors, who may chose to sell it off at any given moment. Naturally, there are reasons that this hasn't happened yet, but as the financial crisis hits the reality of the business world, these concerns are becoming ever more prevalent. If these concerns were ever to become a reality, then entire international monetary system could collapse. The irony is that it's the current international monetary system that led to this problem in the first place. In an effort to illustrate

this issue, I will first analyze the nature of the US public debt and its buyers, other factors in the US-Chinese relationship, the current situation, the role of sovereign wealth funds, and finally what this means for the world as a whole.

*The Nature of US Public Debt and its Buyers.* The biggest holder of Treasury debt is the United States government, with around 52 percent (Schoen 1). Most of these holdings come in the form of Social Security and Medicare. This leaves the rest in public hands, of which the largest percentage is held by foreign governments. In 2007, this was around 25% of \$8.5 trillion (Schoen 1). Other holders include state and local governments and individual investors, but these factors are beyond the scope of this paper, as this section will focus on the international sphere. Before going into the details, however, it is important to understand the basics of the treasury debt buying process. Schoen describes Treasury securities as “a big batch of IOUs that are auctioned off every three months” (1). This is true in its simplest form. As the auction date approaches, the Treasury decides how much it will need to cover the government’s needs. When the auction arrives, buyers submit bids in the form of the interest rate they are willing to accept (1). They are given a choice between making a competitive bid, which is asking for a specific rate, or a non-competitive bid, which is accepting the average rate of other winning bids. Once the bids are in, the Treasury starts accepting the bids at the bottom of interest rate spectrum, and continues to accept them until they have enough money to cover their borrowing.

The life of the Treasury bond doesn't stop there. Once issued at auction, Treasury securities "enjoy a healthy second life when they're traded in the so-called 'secondary market (aka the bond market)'" (2). The prices of bonds bought on this open market vary as the market reacts to outside factors (including speculation, inflation, etc). Once the bond is bought, however, regardless of the price a person pays for it, the government owes the full amount that was borrowed when the debt was first auctioned and borrowed. This fact is important to the rest of this section.

So then, the question becomes which foreign investors exactly own these Treasury securities. In order to display this information, I have compiled a chart from the Treasury website:

**Major Holders of Treasury Securities (in billions of dollars)**

<i><b>Country</b></i>	<i><b>Feb-10</b></i>	<i><b>% of Total</b></i>	<i><b>9-Feb</b></i>	<i><b>% of Total</b></i>
<i>China</i>	877.5	23.40%	744.2	23.54%
<i>Japan</i>	768.5	20.49%	661.9	20.90%
<i>United Kingdom</i>	231.7	6.18%	129	4.08%
<i>Oil Exporters</i>	218.8	5.83%	181.8	5.75%
<i>Brazil</i>	170.8	4.55%	130.8	4.14%
<i>Hong Kong</i>	152.4	4.06%	76.3	2.41%
<i>Carib Banking Cntrs</i>	144.5	3.85%	189.5	5.99%

<i>Taiwan</i>	121.4	3.24%	72.6	2.30%
<i>Russia</i>	120.2	3.20%	130.1	4.11%
<i>All others</i>	944.2	25.18%	845.3	26.74%
<i>Grand Total</i>	3750.5		3161.5	

*Major Foreign Holders of Treasury Securities, [www.treas.gov/tic/mfh.txt](http://www.treas.gov/tic/mfh.txt)*

As the table illustrates, China and Japan are the two largest holders of foreign debt, with a total of around 44%. They allow the United States to run such a high debt because the US is such a strong economy and such a large customer that they want them to continue buying exports. Overall, the amount of foreign investing in US Treasury securities has increased by almost double. The current figure, as previously mentioned, is 25%, but it was less than 13% in 1988 (Treasury Report 5). Government debt is inherently not a problem. The problem is when these foreign securities turn into a national economic and security issue.

*China and U.S. Economic Relations.* The Chinese economy was around \$8.8 trillion in 2009, thus making China the world's third largest economy, right after the United States and the European Union (Amadeo 1). It is also the world's second largest exporter (right after the EU), and the U.S. in particular relies heavily on the Chinese exports. Reversely, the Chinese also rely heavily on the United States, but as time goes on, this lessens. China has recently been increasing trade with Hong Kong and Japan, as well as the African and Latin American countries. Yet the standard of living is relatively low in China, which they use as a method to keep labor, and in

turn exports, cheap. It depends on keeping the value of the yuan low, and in order to do this, it needs to keep the value of the dollar high. A low yuan ensures cheap labor, and the Chinese have managed to keep this a reality despite US pressure to raise the competitiveness of the yuan in an effort to improve American competitiveness. China has also fixed the value of its currency to the dollar. Currently, the dollar is worth around 6.8 yuan (Amadeo 1). If China were to let their currency float, many analysts believe it would be more valuable than the dollar due to the strong Chinese economy. Yet China keep its pegged in order to, once again, ensure cheaper products than the US, thus keeping export and trade deficit with the U.S.

Even beyond the US Treasury securities debate, the economic relationship between the United States and China is tense, at best. While the details of these tensions are beyond the scope of this paper, the mood surrounding the securities debate play a large role, and the past tensions play a role in this mood. So its important to understand the level of competition that exists between the two countries. The United States is the leading world power, and China is the rapidly growing threat. The United States has developed to the point that it is no longer a huge manufacturer and is instead moving towards a service based society. China manufacturers the goods that the United States needs and at the same time, relies on the money the US pays for the goods. Congress is continually accusing China of surpassing import quotas, and China is constantly accusing the United States of protectionism. This tense economic relationship will continue to exist for so long as the two countries need each other, but the question is what happens to the US if China reaches a point where they no longer are in need of the US?

*The Current Situation.* With all these factors coming into play, the current situation is particularly tense. The financial crisis has highlighted these tensions to the point that many economists are concerned. Early this year, China began to sell U.S. securities, and they have currently fallen by \$62.4 billion since last July (Craft 1). Bond markets haven't yet crashed due to Japan, the UK, and oil exporting countries picking up the slack and adding around \$258 billion to their combined holdings (Craft 1). Even so recently as February, China trimmed its holding of US Treasury debt by 1.3 percent, making it the fourth consecutive decline (Crutsinger 1).

In an article by the Associated Press, Win Thin, a senior currency strategist at Brown Brother Harriman & Company said that he believed "the March report could well show a rebound in purchases by China...[and] that part of the changes [in the past terms] reflected a decision by China to rebalance its holdings away from shorter-term Treasury bills" (Crutsinger 1). He maintains that China is "still a steady buyer of U.S. Treasury notes and bonds but has [simply] been paring back its Treasury-bill holdings" (1). Another explanation is that Chinese investors may be simply buying their securities through Britain and Hong Kong (Crutsinger 1).

Despite these reassurances, however, the problem remains. Unless foreign demand for U.S. Treasury debt remains strong, the interest rates that the government pays on the debt could rise exponentially, thus making the deficit of the United States even worse. These rising interest rates would also put an upward pressure on private debt (Crutsinger 1). This upward trend in borrowing costs would affect U.S. businesses and consumers. Higher costs lead to lower consumption



and lower borrowing/lending. It could ultimately freeze up the credit lanes, which would add another risk to the U.S. economy.

Furthermore, as the debate about what China is doing with their holdings rages onward, the United States is also increasingly concerned about the Chinese allowing the yuan to rise in value against the dollar. By doing so, they are keeping the currency artificially low and harming US economic international growth. It is estimated that by doing so, it would add an estimated \$2.4 trillion to the world's supply of Treasury debt this year (Craft 1). President Barack Obama has addressed this issue. He met with President Hu Jintao of China the week of April 13<sup>th</sup> in an effort to "move toward a more market-oriented exchange rate" (Mr Obama and Mr. Hu 1). Mr. Hu reportedly responded that China did plan to move away from the fixed currency peg, but did not say when. China did report that they would not be responding to foreign pressure, the decision would be made on their own time frame.

*The Role of Sovereign Wealth Funds.* Another point of contention in terms of Chinese-US economic relations are sovereign wealth funds. Until recently, China, Japan, and other exporters have been content with keeping "most of their trillions of dollars in reserves in safe investments like bank deposits and United States Treasury debt" (Times 1). As previously demonstrated, these holdings are currently in doubt, but analysts aren't entirely sure where the next step for China would be. As the investment in US treasury debt declines, the investment into the private sectors for higher returns is increasing. With this huge base, government investors diversity

more and can risk higher yielding options. These highly diverse, national funds are called sovereign wealth funds.

The term, according to the New York Times, applies “to government-owned funds set up by the world’s leading exporters, especially China and the major oil producers, that are being employed more assertively for investment in banks, private companies, equity funds, real property and other assets” (1). The funds gained in popularity during the pre-financial crisis years of 2006 and 2007. Many saw the funds as engaging in “cross border nationalization” (Sovereign Wealth Funds 1). This was concerning due to the power that the home government of the sovereign wealth funds might have in the countries where they invest. The Western world is particularly concerned due largely to the fact that the countries yielding these funds aren’t the most stable, or friendly, of allies. Political leaders are concerned that these funds are concealing attempts to invest for political gain or influence.

The role of these institutions has been severely diminished in the wake of the financial crisis of 2008. Many of these sovereign wealth funds had invested heavily in institutions that went south. Of particular interest here is the China Investment Corporation, the Chinese SWF. They originally had a \$3 billion investment in Blackstone Group, but when the group turned downward, the Chinese government lost a degree of latitude. Other SWF’s have done much better. The sovereign wealth fund of Kuwait made “a profit of \$1.1 billion on its \$3 billion investment in Citigroup” (Times 1).

Concern still exists, however, despite the decline of China's SWF in the aftermath of the 2008 financial crisis. The Peterson Institute of International Economics currently says that the biggest SWF's are owned respectively by United Arab Emirates, Singapore, Norway, Kuwait, Russia, and China. It wouldn't be surprising to see China soon take the lead here due to their \$1.3 trillion in foreign exchange reserves. Given the concerns of the Western world about the political influence of such funds, this is not an ideal situation for the United States. The Chinese government already owns 20% of United States foreign debt, and to increase their power with politically placed, powerful funds, wouldn't bode well for national or economic security.

*What this means for the United States and the rest of the world.* As of now, there is no danger of the Chinese selling off their current hold of US Treasury debt. The United States and China are still heavily reliant upon each other, and the US dollar maintains a stronghold in the world economy. However, imagining the worst, if the Chinese sold all of their US debt, the dollar would collapse, sending the United States into a recession never before seen. This is most improbable.

The rest of the world is also affected by the growing debt problems of not just the United States, but a variety of countries. There have been sharp rises in government debt in general, not just the chronic problem of the United States, and many institutions, the IMF included, are concerned about growing sovereign risk. Slow growth in the real economy and high levels of unemployment (and the "jobless

recovery”) will keep tax revenues low and thus require higher government spending to help counteract this.

I include this just to prove the point that despite recent improvements in economic forecasting, the financial system has yet to be restored. Quality must be improved in a variety of areas, but until it is, investors remain jittery. As they worry about long-run government solvency, bond prices could decline in the most advanced economies. If this were to happen, banks, especially those just recovering from the most recent series of hits, could face even new hits. Rising interest costs on public debt also factor here as they could flow through the private sector, raising borrowing costs for all involved (Rowe 1). The relations with China affect all of this, and it highlights the interconnectedness of the economies and the international monetary system today.

### **A Reformed Monetary System**

As the previous two sections highlight, the world is currently undergoing a series of changes. Europe is facing its own internal debt crisis, but the fact that it is the world’s largest exporter, and one of the largest economic blocs in the world, make the issue international. The same holds true for Chinese-U.S. economic relations. The financial crisis has made this situation much worse, and the international monetary system is teetering on the edge of collapse. As the background section highlighted, there have been definitive moments of change in the history of the monetary system. This is one of those moments. Before the system collapses around us, a new system must be enacted. The ideas for such a system have long been debated, but

here I will outline what I see as some of the more feasible options. The bulk of my thesis has been devoted to proving that there was a reason to change so a large, detailed section here is beyond the scope of my research. Because of this I will highlight a only a few ideas.

The need for a revised system has been noted by several world leaders. Nicolas Sarkozy has said, “we must rethink the financial system from scratch, as at Bretton Woods” (Eurodad 1). Furthermore, at the G20 conference this year, a realignment of currency exchange rates was discussed. Most recently, Prime Minister Papandreou of Greece wrote an op-ed in the International Herald Tribune. He wrote the following:

“Democratic governments worldwide must establish a new global financial architecture, as bold in its own way as Bretton Woods, as bold as the creation of the European Community and European Monetary Union. And we need it fast. Only this will build a new confidence and fairness that our citizens can trust, and that can prevent each new crisis from becoming an epidemic” (Papandreou 1).

The desire to recreate the international monetary system is there, but now the cooperation of the world is necessary.

The first of these reformation ideas was promoted by World Bank president Robert Zoellick. In a speech during 2008, he called for a “new multilateral network for a new global economy” (Eurodad 1). Essentially, the G7 is not working, and it is an outdated mode of viewing the world. Zoellick suggested a new steering group including the nations of Brazil, China, India, Mexico, Russia, Saudi Arabia, South Africa, as well as the current G7 members. Yet it is important to recognize that simply putting new countries on the “steering group” will not remake the system. It would simply be updating an old and tired system. The system needs to be reevaluated on a ten-year basis as to note the growths in the world.

The IMF must also be reformed. The financial sector assessment program was launched by the IMF just after the Asian financial crisis in an effort to identify the risks and problems in bank regulation. The United States proved to be difficult in these negotiations and only signed on around 2007. The IMF, which has been frequently criticized for being under the thumb of the United States, recognized the slowdown in the recent US housing market collapse well before the collapse actually took place. It noted that “this weakness has been contained to certain portions of the subprime market..., and is not likely to pose a series systematic threat” (Eurodad 1). Obviously, this prediction failed to happen. Developed, economic powerhouses are used to conducting the world’s economic direction, and the institutions designed to help the underdeveloped, such as the IMF and World Bank, are reluctant or unable to prevent this. The recent Financial Stability Report has indicated that the “financial crisis that emerged from the United States has established a very challenging environment for some countries, especially those with a greater reliance on short-

term flow or with leveraged banking system funded internationally” (Eurodad 1). The IMF failed to act on what would eventually become the global financial crisis of 2008. The actualities of reform are well beyond the scope of this paper, but the point I hope to make is that critical need with which it must be done.

The original ideas of the IMF remain sound, however, and many countries would like to see an enhanced role for the IMF just in a different capacity. The IMF could be used to “improve surveillance of complex financial markets and help prevent such excesses building up in the future” (Seager 1). The role of the IMF needs to be once again clearly defined. They have in recent years morphed into a similar institution as the World Bank when in reality they were designed to do entirely different things. The IMF should be in charge of regulating the financial markets, which have in recent years been far too weak. The resulting global financial crisis has proven this. Yet such an organization as the IMF could “force banks to hold greater capital cushions or make them pay bonuses in shares that would be held in a company, for say five years, to make sure it was the longer-term interests of the shareholders that was the focus rather than the banker’s short term interests” (Seager 1). Basically, I see the IMF performing the role as an international regulator.

The World Bank is also in dire need of reform. Many of the policies proposed by the Bank for poverty alleviation in the global south have disastrous effects on the environment. The large infrastructure projects it promotes adhere to Western values and ideals, and in many cases have proved to be “economically unsound, destroyed pristine rainforest, rivers, and estuaries, and have uprooted the

livelihoods of millions of Third world citizens who are affected by them (Chebucto 1). The World Bank Structural Adjustment Programs have also recently come under fire for their environmental unacceptability and their adherence to Western economics.

Before implanting these reforms, however, we must first rid ourselves of the global financial crisis that plagues the world. Unsustainable debt has become a problem, and the countries that have a surplus, i.e. Germany, must step in to help solve this short-term liquidity crisis. This is obviously a very complex idea and issue with much to be said. Yet, once the world has worked through these issues, then we can step up and do the reformations necessary.

In conclusion of this section, I would like to say that these are simply ideas, not a concrete plan of reformation. A concrete plan would require years of thought. A policy idea gone right usually takes time and many small scale tests. As this is the entire international monetary system that we are discussing, I would advocate nothing less.

### **Conclusion**

The international monetary system has come a long way since the early days of the gold standard. It began with the gold standard in the 1800s, has been interrupted by two major world wars, created two of the largest financial institutions the world has ever seen, and weathered multiple financial crises. Yet as we approach the next era, it is questionable as to whether the system as it is today can exist. The euro crisis and the Chinese holding of US Treasury debt are two of the largest issues the system



has ever faced, and when we look back on the history of the system, it can be seen that in times of big issues, the system changes irrevocably.

With this in mind, it is time that we begin to formulate the system in the way that is best for the world, and not simply let what happens happen. As the 1970s indicated, this is not necessarily the best mode of action. We did that then and ended up with the highly volatile system that we have today. The time for action and creation is now.

The ultimate goal of this thesis was to highlight this urgency. The system has evolved considerably and it is yet to finish. So long as we live in a global world, there will be a need for a global system, and unlike ever before, its time to create a truly equalized, globalized international financial system.

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